BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
LEROY AND GERALDINE KUREK)

Appearances:

For Appellants: Sam Lebowitz
Accountant

For Respondent: Richard A. Watson
Counsel

O P I N I O N

This appeal is made pursuant to section 18594 of the Revenue and Taxation Code from the action of the Franchise Tax Roard on the protests of Leroy and Geraldine Kurek against proposed assessments of additional personal income tax against them separately in the amount of $31.11 each for the year 1965 and against them jointly in the amounts of $271.46 and $476.77 for the years 1966 and 1967, respectively.

In 1957 Stewart McIntyre and his father formed a partnership to act as advertising sales representatives for the publishers of various technical journals. The partnership entered into contracts of approximately one-year duration with various publishers whereby the firm

obtained the exclusive right to represent the publishers in certain defined geographical areas. The contracts were cancellable by either party upon 60 or 90 days' notice. In 1962 the partnership was incorporated with a stated capital of $2,000. Twenty shares were issued, 18 to Stewart McIntyre and the remaining two shares to appellant, Leroy Kurek, then a corporate employee. During the same year McIntyre gave appellant six additional shares.

In 1964 McIntyre became interested in entering the import-export business. At about the same time the corporation lost one of its major clients. Early in the following year McIntyre, eager to commence his new enterprise and-discouraged by the loss of the major account, offered to sell his 60 percent interest in the corporation to appellants. The sale was consummated and its terms reflected in an agreement drafted by the parties' attorney and dated July 15, 1965. The agreement provided for the transfer of McIntyre's shares to appellants for $36,000. As part of the same agreement McIntyre agreed not to compete for a period of five years in the territories where the corporation was then doing business. However, no portion of the purchase price was allocated to the covenant not to compete. At the time of the sale, the corporation's cash, office equipment, and receivables less payables were valued at $6,890. No value was assigned to the contracts giving the corporation the exclusive right to sell advertising in certain areas.

In their 1965 separate returns, appellants treated $4,134 (60% of $6,890) of the $36,000 purchase price as being attributable to the assets carried on the corporation's books, unilaterally allocated the remaining $31,866 to the covenant not to compete and commenced to amortize it over the covenant's five-year life. Appellants continued to amortize the covenant in joint returns filed in each of the years in issue after 1965. Respondent disallowed all the amortization of the covenant not to compete during the years in question. Appellants contend that the covenant not to compete was an integral part of the transaction and that the amortization deductions were proper. Respondent contends that

in view of the absence of a recital of value for the covenant in the agreement and the covenant's lack of economic significance, appellants' unilateral valuation should be disregarded and that the amortization deductions were properly disallowed.

The sole issue for determination is whether any part of the purchase price which appellants paid for the stock and the covenant not to compete may be amortized;

Under appropriate circumstances, section 17208 of the Revenue and Taxation Code authorizes the amortization of covenants not to compete. In order to amortize such a covenant it must be established that the parties realistically and in good faith attached an independent value to the covenant and intended, bilaterally, to allocate a. portion of the purchase price to the covenant not to compete at the time they entered into the agreement . (Annabelle Candy Co. v. Commissioner, 314 F.2d 1; Reuben H. Donnelley Corp. v. United States, 257 F. Supp. 747; Appeal of Jay Briggs, Cal. St. Bd. of Equal., Jan. 4, 1966.) Here, the parties failed to allocate any portion of the purchase price to the covenant not to compete. Although the lack of a recital of value for the covenant in the agreement is not always fatal, in its absence appellant must show that the parties, both the buyer and the seller, nevertheless intended to allocate consideration to the covenant not to compete. (Annabelle Candy Co. v. Commissioner, supra; Reuben H. Donnelley Corp. v. United States, supra.) This appellants have failed to do.

There is no evidence of any discussion between appellants and McIntyre concerning an allocation of a dollar value to the covenant. The purchase agreement and covenant not to compete were drafted by an attorney which further emphasizes the fact that the parties did not intend to allocate any part of the purchase price to the covenant. Most importantly, the covenant was of little independent economic significance since, at the time of the sale, McIntyre was not inclined to compete. The business had just lost one of its major accounts and McIntyre was most reluctant to undertake the task of replacing this account. Furthermore,

McIntyre was anxious to launch into his new enterprise, the import-export business. The only evidence of a value for the covenant is appellants' unilateral allocation. It is well settled that a unilateral allocation of value to a covenant not to compete will not be recognized even where the covenant has independent economic significance. (Annabelle Candy Co. v. Commissioner, supra; Reuben H. Donnelley Corp. v. United States, supra; see also Commissioner v. Killian, 314 F.2d 852.) Certainly, this principle applies with even more vigor where, as here, the covenant not to compete is of little economic significance.

Appellants' reliance on Christensen Machine Co., 18 B.T.A. 256 and Wilson Athletic Goods Mfg. Co. v. Commissioner, 222 F.2d 355, is misplaced. In Christensen, the covenant not to compete was an essential element to the contract without which the purchaser would never have completed the transaction. (See Christensen Machine Co. v. United States, 50 F.2d 282, 287.) The covenant also had substantial economic significance whereas the covenant in the instant matter did not. Similarly in Wilson the covenant not to compete was the key element of the entire transaction. In that case the court was able to determine the existence of an intent to allocate as well as the amount of the allocation. Such is not the situation here.

Accordingly, we conclude that no part of the purchase price which appellants paid for the stock and the covenant not to compete may be amortized. Therefore, respondent's action in this matter must be sustained.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protests of Leroy and Geraldine Kurek against proposed assessments of additional personal income tax against them separately in the amount of $31.11 each for the year 1965 and against them jointly in the amounts of $271.46 and $476.77 for the years 1966 and 1967, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 27th day of March, 1973, by the State Board of Equalization.

_____, Chairman

_____, Member

_____, Member

_____, Member

_____, Member

ATTEST: _____, Secretary